



LARGE AND MID-SIZE
BUSINESS DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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MEMORANDUM FOR INDUSTRY DIRECTORS
DIRECTORS, FIELD OPERATIONS
DIRECTOR, FIELD SPECIALISTS
DIRECTOR, PREFILING AND TECHNICAL
GUIDANCE

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SUBJECT: Field Guidance on the Planning and Examination of
Developer Inducements

Introduction

This memorandum provides guidelines for the efficient use of audit time and resources devoted to the examination of "Developer Inducements."

This is a LMSB directive and is neither an official pronouncement of the law nor position of the service and cannot be used, cited or relied upon as such.

Background

Amounts paid to retailers as inducements to "construct, open and operate," or to "continue to operate" a retail store are frequently encountered in the retail industry. The purpose of such inducements is to have an anchor or "magnet," store, in order to better attract and retain rent-paying stores, in a traditional shopping mall setting.

This paper addresses payments made to a retailer who either has or will have legal title to the building, and either has or will have legal title to the real property on which the building stands, or has or will have a ground lease of such duration that the retailer effectively owns the realty.

This guidance is not intended to address leaseholder inducements. Leaseholder inducements are subject to the safe harbor provisions of Internal Revenue Code Section 110.

Current Tax Controversy

The controversy involves the proper tax treatment of amounts paid to a retailer by a developer, as a cash inducement "to construct, open and operate" or to "continue to operate" an anchor store in a shopping mall, under the terms of a written agreement, when the inducement is excludible from gross income as a non-shareholder contribution to capital under Internal Revenue Code Section 118.

Internal Revenue Code Section 362(c)(2) provides that the basis of any property acquired with a contribution to capital by a non-shareholder shall be reduced by the amount of the contribution. The examination issue thus is whether these excludible amounts should first be applied to reduce the basis of 39-year property, or should be allocated on a pro rata basis, to reduce the basis of all 5-year, 15-year, and 39-year property involved in constructing, opening, and operating the anchor store.

Planning and Examination Guidance

Developer Inducements in general are cash payments made either to encourage a retailer to enter a mall in the first instance, or as an incentive for a retailer to continue to operate its store in the developer's mall. In each case the payments are made as part of a contractual agreement, with a stated time period during which the retailer agrees to operate its store in the mall.

In the case of a payment made to initially induce a retailer to open a store in the mall, the contract typically provides that the retailer shall "build, open and operate" a retail store in the developer's mall. In most cases, total payments are less than total Section 1250 expenditures incurred. In these situations it should be assumed that the parties intended the payments to be allocable entirely to Section 1250 property. The Service would have to show affirmative evidence that the parties to the contract intended differently, in order to vary the taxpayer's treatment of the payments. In most cases this would be difficult, time-consuming, and of limited utility. Thus, in cases in which the developer inducements are less than or equal to the total Section 1250 expenditures incurred, examiners should not challenge the taxpayer's allocation of the inducements for purposes of the Section 362(c)(2) basis adjustments.

A distinction should be made, and additional development should be done, if the total initial cash inducements exceed the total cost to build the retailer's Section 1250 property. That is, in situations in which the total inducements provided exceed the cost of the Section 1250 property, it may be that the parties intended for some portion of the cash to be used on property other than the building itself.

The second most common form of cash inducement is generally paid as an incentive to stay and operate an existing store, once the term of the initial inducement agreement (if there was one) has expired. The agreements pertinent to this inducement may be silent as to the intended use of the monies. Examination should focus on the contract language to the extent possible. More consideration of examination risk should be given when inducements are to stay rather than to build. Particular attention should be paid when the agreements pertinent to the inducements to stay place no restrictions on the use of the monies. In these situations, the actual use of the funds may well be an appropriate guide to the reduction in basis. Correlations among the amount, type and timing of improvements may well give rise to reasonable inferences about the intended use of the inducement payments.

Definitions

Anchor (Magnet) store: An anchor magnet store is typically a larger retail department store whose presence in an enclosed shopping mall or an upscale strip center draws customers not only to the anchor store itself, but also to the more numerous and higher-rent paying interior tenants.

Developer Inducements: Payments made as an inducement to attract and retain quality stores.

If you have any questions, please contact Gregory W. Pierce, Senior Program Analyst, Retailers, Food, Pharmaceuticals & Healthcare, at 630-493-5934 or (Currently Vacant), Technical Advisor, Retail.

cc: Commissioner and Deputy Commissioner, LMSB
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